Reply Affidavit of Richard J. Gilbert and Robert G. Harris
on behalf of SBC Communications, Inc. and Ameritech Corporation

STATE OF CALIFORNIA)
) ss
COUNTY OF ALAMEDA)

I, Richard J. Gilbert, being duly sworn, depose and say:

I, Robert G. Harris, being duly sworn, depose and say:

We have been asked by SBC Communications Inc. and Ameritech Corporation to respond to various comments and petitions filed concerning their application seeking the approval of the Federal Communications Commission to transfer control of certain licenses and authorizations from Ameritech to SBC.

In particular, we have been asked to address arguments that wrongly allege that the proposed transaction would not create significant consumer benefits and to refute certain arguments that the proposed transaction would be anti-competitive.

The attached report contains the results of our analysis and the bases for our conclusions that the arguments that the proposed transaction would not have significant pro-competitive effects are incorrect. Our review of the comments and petitions filed in connection with this transaction confirms our prior view that this transaction would be good for consumers and good for competition.

We declare under penalty of perjury that the foregoing is true and correct to the best of our knowledge and belief.

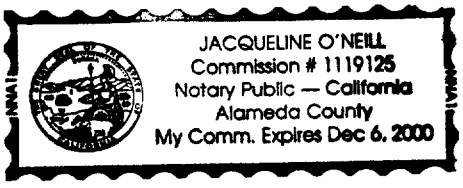
Richard J. Gilbert

Robert G. Harris

Subscribed and sworn before me this 12th day of November, 1998

Notary Public

My commission expires: December 6, 2000



BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

In the Matter of Applications for Consent to the Transfer of Control of Licenses and Section 214 Authorizations from	)	
AMERITECH CORPORATION, Transferor	)	CC Docket No. 98-141
to	)	
SBC COMMUNICATIONS INC., Transferee	)	

JOINT REPLY AFFIDAVIT OF RICHARD J. GILBERT AND ROBERT G. HARRIS ON BEHALF OF SBC COMMUNICATIONS

November 16, 1998

Table of Contents

I. INTRODUCTION 1

II. OPPONENTS WOULD STOP AN SBC-AMERITECH MERGER THAT IS PRO-COMPETITIVE 2

III. CONSUMER BENEFITS OF THE MERGER 6

A. INCREASES IN EFFICIENCY 7

1. Efficiency Gains to Consumers 7

2. Service Quality Will Increase Because of the Merger 8

3. The Merger is Needed for the Diffusion of Best Practices 9

4. Economies of Scope Require a Merger 12

5. One-Stop Shopping 13

B. BENEFITS THROUGH INNOVATION 16

C. GLOBAL COMPETITION 21

IV. THE MERGER WILL NOT HARM COMPETITION 23

A. THE MERGER DOES NOT LEAD TO INCREASED CARTEL POSSIBILITIES 23

B. THE MERGER DOES NOT DISCOURAGE SMALLER ENTRANTS 25

C. THE MERGER WILL BRING COMPETITION TO RESIDENTIAL MARKETS 32

D. EFFECTS OF THE MERGER ON INTERNET COMPETITION 34

1. Tying ISP and xDSL Services 35

2. Applying Access Charges to ISP Service to Price-Squeeze Non-Affiliated ISPs 37

3. Obtaining Market Power in the Internet Backbone Market 39

4. The Merger is Likely to Lead to Benefits to Internet Consumers 41

V. CONCLUSION 41

I. Introduction

1. This affidavit responds to a number of economic policy issues raised by opponents to the SBC-Ameritech merger. In general, opponents attempt to dismiss the benefits that the merger would bring and, instead, hypothesize about negative outcomes they believe would happen if the merger were allowed to proceed. This affidavit shows that the benefits discussed in our initial affidavit are based on sound economic theory and are substantiated by previous experience.

2. It is insightful that opponents present a wide range of issues, none of which has any substantial antitrust content. The central fact is that the merger will not harm competition in any market. The SBC-Ameritech merger is a deliberate effort to create a firm that matches marketplace requirements. It is motivated by the desire of SBC and Ameritech to be an effective and lasting competitor in a wide variety of domestic markets and on a global scale. Our evidence makes it clear that SBC and Ameritech are not alone in pursuing this strategy. Other major players, many of whom are opposing this merger, are also configuring themselves and their services for the rapidly evolving telecommunications marketplace. These competitors oppose the merger because their best interests do not lie in the creation of a stronger competitor.

3. Our discussion of the economic and public policy issues presented by opponents addresses a number of focused areas. Section II describes how delay or prevention of this merger would harm consumers and competition and would not be in the public interest, although it would be in the best interests of competitors. Section III contains a discussion of the consumer benefits that will result from the merger. It addresses the attempts by opponents to discount or totally dismiss these benefits and reveals the fallacies in their assertions. Finally, Section IV refutes certain arguments made by opponents that the merger would harm competition.

II. Opponents Would Stop an SBC-Ameritech Merger That Is Pro-Competitive

4. The large IXCs, AT&T, MCI WorldCom and Sprint, all filed extensive comments in opposition to the proposed merger. When assessing the opposition of the large IXCs to this deal, it is important to note that they are strongly motivated to stop this merger in order to prevent the creation of a stronger competitor. Ameritech and SBC, as separate entities, would be less well positioned to compete in the dynamic, rapidly changing telecommunications market. Many national firms have filed statements in this matter noting that SBC alone does not have the size or geographic scope to serve all its telecommunications needs. To quote Shell, "Despite the partnership approach Shell and SBC have adopted, there are important telecommunications needs of the company, which SBC today is unable to satisfy. For example, Shell did not even consider SBC in its most recent solicitation of bids to provide long distance voice and data services because of SBC's inability to provide service in certain areas of the United States."[1] The global evolution of the telecommunications marketplace demands that firms structure themselves in efficient and customer-focused ways. That is precisely the motive behind this merger.

5. The SBC-Ameritech merger is pro-competitive, both at the local level as a result of the National-Local strategy and other competitive benefits, and at the long distance level by positioning the new SBC-Ameritech combined entity to be a significant player among the few large global long distance players.

6. Telecommunications is no longer local, long-distance or international; it is truly global in scope. The importance of international telecommunications capabilities has increased

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[1] *Comments of Shell Oil Company,* Before the FCC, CC Docket No. 98-141, October 1, 1998, page 2 (hereinafter "Shell Oil Comments"). See also, *Comments of Ultramar Diamond Shamrock*, Before the FCC, CC Docket No. 98-141, October 12, 1998, pg. 1, and *Kahan Reply Affidavit*, Before the FCC, CC Docket No. 98-141, November 16, 1998, ¶¶ 15-20 (hereinafter" Kahan Reply Affidavit") for similar comment from other customers.

dramatically in the last decade, driven by the ever-increasing globalization of trade and industry. Corporate customers who are not confined to a narrow geographic locale now demand that their telecom providers be able to seamlessly provide and integrate multiple services across the globe. One such customer recently noted: "our telecommunications needs are not just a matter [of] regional offices buying voice lines from the state provider...What we are tending to do is buy voice and data lines from one or two providers for our world needs."[2] They simply will not settle for less.

7. The IXCs themselves are well aware of the changing nature of competition in the telecommunications industry, and actively promote the fact that they are able to offer one-stop shopping and integrated services because they know customers demand such service. For instance, MCI WorldCom, in filings to support its own merger, noted, "By creating a more effective and multi-faceted carrier in the local exchange sector, the proposed merger will significantly enhance competitive choice for U.S. telecommunications customers, and advance, further than perhaps any other initiative, realization of the underlying intent of Congress and the Commission in implementing the Telecommunications Act of 1996."[3]

8. MCI WorldCom and AT&T also tout these same benefits of integrated services in their public statements and advertising campaigns. For instance, MCI states the following about its integrated service offerings: "While other communication companies are talking about building a seamless network, or planning to build one, or conjuring images of building one, MCI

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[2] Sari Kalin and Torsten Busse, "BT-MCI merger wields weight worldwide," *InfoWorld*, <<http://www.infoworld.com>>, December 9, 1996. See also *Shell Oil Comments*, "A carrier's ability to provide all or a substantial bundle of services to the company is highly valued," p. 2; and other cites in *Kahan Reply Affidavit*, ¶¶ 15-20.

[3] *Applications and Request for Special Temporary Authority Volume One*, In the Matter of Applications of WorldCom, Inc. and MCI Communications Corporation for Transfer of Control of MCI Communications Corporation to WorldCom, Inc., Before the FCC, CC Docket No. 97-211, October 1, 1997, §I.A.1.

WorldCom's network is here today. The only local-to-global network in the world."[4] AT&T states in relation to its merger with TCG, "Joining forces with TCG will speed AT&T's entry into the local business market, reduce [our] costs and enable [us] to provide businesses the any-distance services they want."[5] And AT&T's latest merger partner, TCI, recognizes that mergers are often necessary to accomplish large scale strategic objectives: "It was clear that to implement [TCI's full-service] strategy, we were going to need a powerful company to help us do this."[6] See, also the comments filed with the FCC by customers referenced in the Kahan Reply Affidavit, ¶¶ 15-20.

9. The merger between Ameritech and SBC would give the combined company a solid base to compete in local, long distance and global telecommunications markets. It presents a key opportunity for another American firm to be among the few global telecommunications players. In fact, the consequences of the merger are strongly pro-competitive by creating another national, integrated carrier. Customers who have filed with the FCC recognize this benefit of the merger. For instance, Ultramar Diamond Shamrock notes, "Our company will benefit directly from the merger. It will mean there is one more major telecommunications company to compete for our business."[7]

10. It is important to note that many of the predictions of harm offered by opponents to this

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[4] MCI WorldCom Advertising Supplement, *The Wall Street Journal*, October 1, 1998 (hereinafter "MCI WorldCom Ad").

[5] Quote attributed to Michael Armstrong, AT&T's Chief Executive Officer. See "AT&T and TCG to Merge; TCG to Become Core of AT&T's Local Services Unit," *AT&T Press Release,* January 8, 1998.

[6] Quote attributed to TCI CEO John Malone. See "AT&T-TCI Merger Banks On Many Unknowns," *Inter@ctive Week*, July 13, 1998.

[7] *Comments of Ultramar Diamond Shamrock,* Before the FCC, CC Docket No. 98-141, pg. 2. See also *Comments of TravelersGroup,* Before the FCC, CC Docket No. 98-141, pg. 1, "The approval of the proposed merger will allow them to expand their services and make the merged company a significant competitor that we can consider in the national and global market."

merger were also used to oppose the previous mergers of SBC-PacTel and Bell Atlantic-NYNEX. None of those dire predictions materialized in either of those mergers. Quite the contrary, those mergers resulted in higher service quality and expanded competition.

11. Finally, opponents cite one of our earlier testimonies on SBC's consideration of out-of-region entry in 1996 as support for the idea that SBC and Ameritech are uniquely positioned as entrants.[8] This, however, ignores the fact SBC and Ameritech have refined their entry strategies over the past two years and the fact that competitive entry by other parties has already reshaped these markets. For instance, Ameritech already faces substantial local competition in Chicago from MCI WorldCom, AT&T, and twelve other facilities based competitors.[9] There is little to be gained from increased competition from SBC in Chicago, and the existing players in Chicago are just as well, if not better, situated to enter other markets in Illinois than SBC. Further, while opponents argue that SBC is a potential entrant in Chicago because it has a cellular system there, SBC spent considerable resources studying the idea of entering the Chicago market, and decided it could not profitably do so using cellular facilities it already had in place.

12. Several opponents argue that the merger increases the incentive and ability of SBC to discriminate against potential competitors in retail services.[10] As other witnesses discuss in detail, and as one of us demonstrated with the SBC-PacTel merger, there is no substance to these arguments. The ability to discriminate arises from the ILECs' control of network elements that

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[8] *Petition to Deny of Sprint Communications*, Before the FCC, CC Docket No. 98-141, October 15, 1998, pp. 8-9 (hereinafter "Sprint Petition").

[9] *SBC Application to the FCC in the Matter of the SBC-Ameritech Merger*, Map 25, Before the FCC, CC Docket No. 98-141, July 24, 1998.

[10] See: *Sprint Petition*, pp. 20-28; *Declaration of Dr. Michael L. Katz and Dr. Steven C. Salop*, on Behalf of Sprint Communications, Before the FCC, CC Docket No. 98-141, pp. 37-51 (hereinafter "Katz and Salop Declaration"); *Declaration of Kenneth C. Baseman and A. Daniel Kelley*, on Behalf of MCI WorldCom, Inc., Before the FCC, CC Docket No. 98-141, pp. 23-29 (hereinafter "Baseman and Kelley Declaration).

other firms must access to provide competing services. Under the opponents' theory, the merger increases incentives to discriminate by allowing the merged firm to internalize the spillovers from its exclusionary behavior. The merger also allegedly increases the ability to discriminate by reducing the number of benchmarks.[11]

13. The opponents' arguments do not withstand scrutiny. As other witnesses discuss in detail, there are still ample and increasing opportunities for regulators to use benchmarks, including CLECs and intracompany benchmarking. In addition, the enlarged footprint of a combined SBC-Ameritech gives regulators greater ability to enforce their requirements. If, for example, difficulties arose in one area through collocation, OSS or interconnection problems, regulators would now have a greater geographic area over which to impose remedies. This greater opportunity to take action actually reduces the incentive and ability to discriminate as a result of the merger.

14. The changing nature of technology in the telecommunications industry, the increased demand for nationwide integrated service, and the inability to engage in the type of anticompetitive behavior hypothesized by the opponents all point to the fact that the proposed merger is strongly pro-competitive.

III. Consumer Benefits of the Merger

15. Opponents raise a number of false arguments seeking to undermine the consumer and efficiency gains that will be derived from the merger. In some cases, these are the opposite of

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[11] *Katz and Salop Declaration*, ¶ 87; *Declaration of Joseph Farrell and Bridger M. Mitchell*, on Behalf of Sprint Communications, Before the FCC, CC Docket No. 98-141, October 15, 1998, pp. 47-48 (hereinafter "Farrell and Mitchell Declaration"); and *Declaration of Stanley M. Besen, Padmanabhan Srinagesh, and John R. Woodbury*, on Behalf of Sprint Communications, Before the FCC, CC Docket No. 98-141, October 15, 1998, p.4 (hereinafter "Besen, Srinagesh, and Woodbury Declaration").

the arguments that some of these very same opponents made in the past in favor of their own mergers. We address each of these assertions in turn.

A. Increases in Efficiency

1. Efficiency Gains to Consumers

16. The Consumer Coalition improperly argues that efficiency gains from the merger will be used to fund the National-Local strategy instead of benefiting consumers through lower prices in their home regions.[12]

17. In fact, the merger creates efficiencies and benefits in four general areas. First, consumers will gain from the ability of the merger to speed up the development and introduction of new products. Second, the merger will generate substantial process innovations through the sharing of best practices, and by providing an increased opportunity to develop new efficiency generating practices. Third, the merger creates a new provider with the scale and capabilities to provide integrated national service, increasing the competitiveness of this important and growing segment of the telecommunications marketplace. Finally, the merger will result in increased competition as the combined company pursues its strategy of entering 30 out-of-region markets.

18. Not only will consumers gain from competitive prices, but new product introductions and process improvements will benefit consumers in all regions, as Mr. Kahan explains was the result of the Pacific Telesis Group merger.[13] For instance, using SBC's substantial cellular experience, PacTel was the first wireless carrier in California to offer a rate plan including all of California

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[12] *Comments of the Consumer Coalition*, Before the FCC, CC Docket No. 98-141, October 15, 1998, p. 12; *Affidavit of Susan M. Baldwin and Helen E. Golding,* on Behalf of the Consumer Coalition, Before the FCC, CC Docket No. 98-141, October 15, 1998, p. 56 (hereinafter "Baldwin and Golding Affidavit").

[13] *Affidavit of James S. Kahan*, Before the FCC, CC Docket No. 98-141, July 24, 1998, ¶ 98 (hereinafter "Kahan Affidavit").

and Nevada as a single calling area with no roaming charges.[14] Additionally, through SBC's ability to generate cost savings in procurement, for example, they were able to offer reduced wireless rates for California's consumers.[15]

19. The merger at once enlarges the learning base for the combined company and will promote the transfer of successful business models between the two. The diffusion of best practices between SBC and Ameritech will lower costs and facilitate the deployment of new services. The merged company will be able to develop and introduce these new services and packages of services at lower cost and more rapidly than SBC and Ameritech could achieve without the merger. Consumers will benefit directly from these new service offerings through increased choice and lower prices.

2. Service Quality Will Increase Because of the Merger

20. The Consumer Coalition incorrectly alleges that service quality will decline because of SBC's use of the efficiency savings to leverage entry into new markets.[16]

21. The evidence is to the contrary. Best practices adopted from both firms will increase service quality. Since the PacTel merger, California customers have experienced a 60 percent reduction in repair time, and an 80 percent reduction in service installation time. In addition, from April 1997 to April 1998, the informal complaint rate on repairs has been reduced by more than 50 percent.[17] These are significant service quality increases that can be expected to occur in

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[14] *Reply Affidavit of Martin A. Kaplan*, Before the FCC, CC Docket No. 98-141, November 16, 1998, ¶ 15 (hereinafter "Kaplan Reply Affidavit").

[15] *Kaplan Reply Affidavit,* ¶ 15.

[16] *Comments of the Consumer Coalition,* Before the FCC, CC Docket No. 98-141, October 15, 1998, pp. 19-20; *Baldwin and Golding Affidavit,* p. 55.

[17] Internal studies of customer satisfaction at Pacific Bell support these results. *Kahan Affidavit,* ¶ 97. See also

new SBC regions, given the approval of the instant merger.

22. Competition forces all firms in the marketplace to respond to the levels of quality and the price-quality tradeoffs that consumers demand. Indeed, an underlying motive of the merger is to give SBC-Ameritech a reasonable opportunity to compete with fully integrated firms. It will be able to compete only by enhancing the quality of its services in the ways consumers demand.

3. The Merger is Needed for the Diffusion of Best Practices

23. AT&T asserts that many of the efficiencies could be gained through other means short of merging, even though, in the past, they have argued that these other means are not substitutes for mergers.[18] Sprint also argues that best practices could be shared without merging.[19] These opponents further believe that the merger may dampen the development and diffusion of best practices because monopoly power diminishes the incentive to cost minimize. This final point is irrelevant to the analysis because the merger in no way increases monopoly power in any relevant market, and thus does not in any way alter the incentive to cost minimize.

24. AT&T, in a similar way, argued in support of its acquisition of McCaw Cellular Communications that, "the transaction would enhance [McCaw's] marketing through access to the AT&T name and to AT&T's marketing channels..."[20] They argued that it would provide a benefit of "increased customer service" through "AT&T's high standards of service."[21] In

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Kaplan Reply Affidavit, ¶ 41.

[18] *Petition of AT&T Corp. to Deny Applications*, Before the FCC, CC Docket No. 98-141, October 15, 1998, p. 5 (hereinafter "AT&T Petition").

[19] *Sprint Petition,* pp. 65-66.

[20] *Application Before the California Public Utilities Commission,* In the Matter of the Joint Application of AT&T and McCaw Cellular to Transfer Indirect Control of McCaw's California Cellular Holdings to AT&T (abbreviated title), August 24, 1993, p. 24.

[21] *Application Before the California Public Utilities Commission,* In the Matter of the Joint Application of AT&T

addition, they stated, "AT&T can assist those affiliates in improving billing, marketing and administrative functions..."[22] All of these arguments were proffered as justification for an acquisition. Presumably, if the same benefits could have been gained through contractual arrangements, the arguments would have been empty.

25. The gains from transferring best practices across firms are identified in the Affidavits of Martin A. Kaplan, Robert Jason Weller, and Wharton B. Rivers filed in this docket.[23] It would be difficult, if not impossible, to adopt most of these best practices across the two firms without integration. It is generally recognized that contractual arrangements are imperfect substitutes for integration in instances where either complex coordination is required or where investments in specific assets are necessary to bring about the efficiency gains.[24] Economists argue against the use of the market for such transactions, but rather suggest that they should occur within the firm, i.e., through a merger.[25] It is impossible to write contracts that can account for all of the possible contingencies leading, at times, to situations where the incentives of the firms are not aligned and dismantling occurs. In fact, a number of the opponents to this merger are in the midst of unwinding their own joint ventures.[26]

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and McCaw Cellular to Transfer Indirect Control of McCaw's California Cellular Holdings to AT&T (abbreviated title), August 24, 1993, p. 27.

[22] *Application Before the California Public Utilities Commission,* In the Matter of the Joint Application of AT&T and McCaw Cellular to Transfer Indirect Control of McCaw's California Cellular Holdings to AT&T (abbreviated title), August 24, 1993, p. 27.

[23] *Affidavit of Kaplan, Weller, and Rivers, Jr.,* Before the FCC, CC Docket No. 98-141, July 24, 1998.

[24] Henry W. Chesbrough and David J. Teece, "When is Virtual Virtuous?" *Harvard Business Review,* January-February 1996, pp. 65-73.

[25] See Williamson, Oliver. *The Economic Institutions of Capitalism.* New York. Free Press. 1985. Also, see Klein, B., Crawford, R., and Alchian, A., 'Vertical Integration, Appropriable Rents and the Competitive Contracting Process,' *Journal of Law and Economics*, 21: 297-326. 1978.

[26] For example, MCI and BT would rather have merged than realize efficiencies through contracts. WorldCom chose to make a competing, higher takeover offer for MCI rather than continue to lease capacity from MCI. This choice is presumably driven in part from the benefits of integrating local operations with long-distance and Internet services and combining facilities. For instance, more local traffic can be carried over the combined

26. Nor would best practices be shared to the same extent without a merger. It is difficult to contract for the transfer of best practices. The value of a best practice is not fully known before the transfer has occurred. The complexity of the best practice technology makes it difficult to measure and account for its value in a market transaction.

27. In addition, the merger increases incentives to invest in best practices because of the higher returns to any unit cost savings that can be earned. Any per unit efficiencies that are learned from the merging partner can be applied to a higher volume and thus create higher returns.

28. In particular, Mr. Kaplan's affidavit itemizes "the synergies SBC expects to derive from its merger with Ameritech Corporation," based on Mr. Kaplan's experience in implementing these productivity improvements in the occasion of the Pacific Telesis/SBC merger. These affidavits clearly lay out how Ameritech will benefit through implementation of a host of SBC's and Ameritech's best practices. They can be summarized in the areas of: vertical features, directory publishing, Centrex type services, information technology, marketing, product development, switching operations and network engineering.

29. As for gaining from Ameritech, Mr. Weller's affidavit points out that "Ameritech has higher productivity (access lines per employee) than SBC's local telephone business, achieved through consolidating its in-region activities."[27] SBC can benefit from Ameritech's experience in consolidating the operations within its five state region by using these same methods to reap similar productivity gains. The incentives for best practices adoption and R&D are increased from the merger because there are higher returns to any given decrease in the unit cost of

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company's own network facilities, reducing the cost of leasing lines and switching traffic. Similarly, GTE's takeover bid for MCI, in competition with the existing BT and WorldCom offers, appears to have been driven by the perceived benefits of integration.

[27] *Affidavit of Robert Jason Weller*, Before the FCC, CC Docket No. 98-141, July 24, 1998.

production or increase in the unit measure of quality.

4. Economies of Scope Require a Merger

30. Interestingly, the opponents realize that economies of scope can be gained from geographic expansion. However, they believe that these economies could be obtained through other means short of a merger. AT&T argues that economies of scope are only geographic and could be obtained through unilateral geographic expansion.[28] Further, it is asserted that purchasing and outsourcing consolidation may reduce public net benefits by raising the cost of outsourcing for independent firms (i.e., outsourcing firms lose scale economies when Ameritech shifts these functions to SBC). Finally, it is alleged that scale and scope economies cannot be obtained because territories are not adjacent.[29]

31. As has been noted numerous times, neither SBC nor Ameritech had any intention of undertaking the kind of geographic expansion envisioned in the National-Local strategy, much less at the accelerated pace the merger will allow. For instance, James Kahan explains that over 8,000 new employees will need to be hired, and that losses in the early years would create an unacceptable (to the investment community) earnings dilution problem.[30] Thus, the merger is integral to obtaining the geographic economies of scope that the opponents acknowledge exist.

32. Second, the internalization of a business function because it is efficient to do so enhances competition and society's welfare. The fact that internalization removes a portion of business from an independent firm is simply an efficient reallocation of resources. A goal of public policy is to protect competition within a given market, not competitors. Thus, to the extent that the

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[28] *AT&T Petition,* p. 49; Also see, *Besen, Srinagesh, and Woodbury Declaration,* pp. 33-34.

[29] *Besen, Srinagesh, and Woodbury Declaration,* p. 33.

[30] *Kahan Affidavit,* ¶¶ 58 and 75.

merger generates economies of scope that decrease costs to SBC, the merger is pro-competitive.

33. Third, many of the efficiency gains do not depend on proximity. As Kaplan discusses, many of these gains will occur at the HQ level.[31] These include, but are not limited to, procurement savings (wireline, wireless, and long distance volume discounts), and consolidation efficiencies (marketing, advertising, R&D, business development, strategic planning, real estate consolidation, and other redundancies).

34. For example, in the PacTel merger SBC took advantage of its technical ability in xDSL service and combined it with PacTel's expertise in working with ISPs and DSL management system technology.[32] The result is a large-scale deployment in California that began this past July. This synergy did not depend on proximity at all.

5. One-Stop Shopping

35. Level 3 Communications and Sprint state that large business customers do not want "one-stop shopping" because they would rather have multiple vendors at the same time to enhance competition.[33]

36. This argument completely misses the point. Large business customers will want the choice of using one of many different vendors. However, many will want to take advantage of one-stop shopping. For example, Shell Oil states that "[a] carrier's ability to provide all or a

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[31] *Affidavit of Martin A. Kaplan,* Before the FCC, CC Docket No. 98-141, July 24, 1998 (hereinafter "Kaplan Affidavit").

[32] *Kaplan Reply Affidavit,* ¶¶ 21-22.

[33] *Comments of Level 3 Communications in Opposition to Application for Transfer of Control,* Before the FCC, CC Docket No. 98-141, October 15, 1998, pp. 10-11; *Sprint petition,* p. 49; *Affidavit of Steven Signoff,* CC Docket No. 98-141, October 15, 1998, ¶¶ 4 and 11; and *Besen, Srinagesh, and Woodbury Declaration,* pp. 10-11.

substantial bundle of services to the company is highly valued..."[34] Further, the Traveler's Group feels that "[t]he approval of the proposed merger will allow them [SBC-Ameritech] to expand their services and make the merged company a significant competitor that we can consider in the national and global market."[35]

37. One-stop shopping is a marketplace goal not just of SBC-Ameritech, but many players, including many opponents of the merger such as AT&T, MCI, and Sprint. For example, Sprint recently unveiled its ION network saying "[our] alliance with RadioShack provides consumers with the ability to go to one place near their work or home to have all their communications questions answered, purchase their products and services, and have those products and services integrated through one communication services provider."[36]

38. Further, as recognized years ago by Carl Shapiro of U.C. Berkeley and one of us,

> "One-stop shopping" may sound like a minor consideration, but even a cursory look at today's telecommunications marketplace reveals that it is not. Much of the flurry of activity among telecommunications firms can be seen as efforts by today's telecommunications providers to form alliances to offer ever-broader ranges of telecommunications services under a common brand name or in a coordinated fashion. Most notable are AT&T's UniPlan Services, MCI's Vision Service and Sprint's Clarity Service, all of which bundle domestic and international long distance calls, 800 calls, fax transmissions and data transmissions over both switched and dedicated access for volume discounts. In addition, AT&T's recent acquisition of McCaw and BT's alliance with MCI demonstrate the IXCs' push to offer seamless, worldwide telecommunications services. Of course, there is also intense activity involving cable operators, cable programmers, movie studios, computer software firms, etc.[37]

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[34] *Shell Oil Comments,* p. 2.

[35] *Comments of TravelersGroup,* Before the FCC, CC Docket No. 98-141, October 14, 1998, p. 1.

[36] Quote attributed to William T. Esrey, chairman of Sprint. See: "Sprint unveils revolutionary network," *Sprint press release,* June 2, 1998.

[37] *Affidavit of Robert G. Harris and Carl Shapiro,* In Support Of Pacific Telesis Group's Request for a Waiver to Permit It to Provide Interexchange Services to Customers in California, Civil Action 82-0192, Before United

39. As technology, competition, and regulation continue to open up the market to alternative providers of telecommunications services, especially for the larger and more sophisticated users, SBC's competitive position will deteriorate vis-à-vis IXCs that can offer a broader range of telecommunications services, including the ability to handle all toll calls. This is one of the reasons why SBC and Ameritech are seeking the ability to offer one-stop shopping.

40. One-stop shopping is not solely a national phenomenon. To meet the increased requirements and expectations of their customers who now operate on a global scale, telecommunications carriers are scrambling to form international marketing alliances.[38] According to Melanie Posey, an analyst with International Data Corp, companies are going global at the request of their multinational customers.[39] Another source states that "multinational users in Europe currently have to buy services from many national telecommunications companies. In the future they hope to be able to buy services for several countries from one source."[40]

41. Further, as MCI itself stated, "the combination of MCI and WorldCom [will] create a pre-eminent provider of one-stop shopping advanced communications services."[41] The opponents apparently agree that one-stop shopping is the future of the industry, as evidenced by their own

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States District Court For The District Of Columbia, January 26, 1995, p. 50.

[38] Bryan VanDussen also said that, "Margins in the international marketplace are probably the last great frontier in the telecommunications business." See: "Telcos go after international markets: Global telecom marketplace will give businesses simplified, cheaper service," *InfoWorld*, July 21, 1997; at <<http://www.infoworld.com>, downloaded July 14, 1998.

[39] "Telcos go after international markets: Global telecom marketplace will give businesses simplified, cheaper service," *InfoWorld*, July 21, 1997; at <<http://www.infoworld.com>>, downloaded July 14, 1998.

[40] Sari Kalin and Torsten Busse, "BT-MCI merger wields weight worldwide," *InfoWorld*, see <<http://www.infoworld.com>>, December 9, 1996.

[41] *Applications and Request for Special Temporary Authority Volume One*, In the Matter of Applications of WorldCom, Inc. and MCI Communications Corporation for Transfer of Control of MCI Communications Corporation to WorldCom, Inc., CC Docket No. 97-211, Before the Federal Communications Commission, October 1, 1997, §III.B.1.

words and actions.

42. Both MCI WorldCom's and AT&T's recent advertisements reflect their recognition of this trend. As MCI WorldCom stated recently, "the artificial communication boundaries of yesterday's networks no longer exist on our network. So all of your local services are now combined with your other services..."[42] It is also stated that "beyond speed, beyond newness, there is something else you can expect from a one-carrier network. Consistency from market to market, the same services, working the same way."[43] They point out the fact that, "One end-to-end network not only means one contract (with better volume discounts, because all services are combined into one account), which is an obvious advantage. It also means you always know who is responsible. The buck (truly) has found a place to stop. And it's here."[44] AT&T CEO Michael Armstrong also recently underscored the importance of one-stop shopping when he said, "[Consumers] can simply access (services) from a single company that has a single connection."[45]

B. Benefits through Innovation

43. Sprint and AT&T argue that the claims regarding R&D benefits are not well supported.[46] Further, they argue that the larger size firm actually will reduce innovation.[47] These assertions

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[42] *MCI WorldCom Ad.*

[43] *MCI WorldCom Ad.*

[44] *MCI WorldCom Ad.*

[45] Bob Tourtellotte, "Experts See Lower prices Ahead for Merged ATT/TCI," Quote attributed to AT&T CEO Michael Armstrong. *Yahoo Daily News,* See <<http://dailynews.yahoo.com/headlines/technology/story.html>> June 25, 1998.

[46] *Sprint Petition,* p. 66; *AT&T Petition,* p. 49.

[47] *AT&T Petition,* p. 49.

are simply wrong.

44. Opponents overlook several important points: (1) R&D is done by a host of different firms, including equipment manufacturers, computer firms, software firms, and large electronics firms in addition to ILECs and other telecommunications providers, (2) the incentive to conduct R&D will be increased by the merger, and (3) the benefits from R&D will be increased with the merger.

45. First, there are currently plenty of innovators, and this merger does not change that fact. The market for research and development for telecommunications products and services is very competitive, and includes numerous and varied participants, including LECs, IXCs, cable providers, wireless providers, equipment manufacturers, Internet Service Providers, and computer manufacturers. This merger will have no impact on this intensely competitive market. Furthermore, the major type of research that the service providers engage in involves the market testing and packaging of products and services. These are types of research SBC's research subsidiary TRI, specializes in; and is precisely the kinds of R&D that will be enhanced by the SBC-Ameritech merger.[48] Market testing and rollout are greatly facilitated and made more efficient by the larger market area, as was the experience with xDSL in PacTel territory post-merger.[49]

46. Second, the combined company's return on R&D investment should increase, as the combined company will provide a better organizational platform to develop and introduce new technologies and services that respond to consumer demands. A primary benefit of the merger is the ability to develop and roll out competing technologies and services faster than would be

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[48] "TRI explores new ways to incorporate leading edge technology into communications products and services. TRI's research efforts produce new products and services that contribute to consumer satisfaction," *Kaplan Reply Affidavit,* ¶ 20.

[49] *Kaplan Reply Affidavit,* ¶ 22.

possible for the companies individually. By combining the resources of SBC and Ameritech, the merger will enhance investment opportunities and speed the introduction of new services and technologies. SBC was able to achieve similar efficiencies from the PacTel merger with technologies such as xDSL.[50]

47. As noted above, the merger will facilitate diffusion of best practices between SBC and Ameritech. In addition to the benefits discussed above, the application of best practices also benefits the merged company by lowering the costs associated with the development and deployment of new products and services. One of the sources of productivity gains in local telephone operations comes essentially from learning-by-doing, especially in the newer applications such as broadband access for residential users through xDSL technology. The merger at once enlarges the learning base for the combined company and will promote the transfer of successful business models between the two. In the SBC-PacTel merger, application of best practices allowed PacTel to generate improvements in the speed of new product introductions by PacTel, and savings in operator and directory assistance, while SBC was able to save capital expenditures for new trunks and tandems through use of PacTel practices.[51]

48. Specifically, improvements in the internal operations of the merged firm will result in faster and broader deployment of existing services, new services that are introduced more rapidly as a result of more effective research and development, and lower production costs that are passed on to consumers in competitive telecommunications markets. There also will be significant benefits from standardization of the design and procurement process for new services. With xDSL, for example, the separate companies each would have to evaluate the myriad of technological approaches, select solutions and vendors, and then commit to production of the

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[50] *Kaplan Reply Affidavit,* ¶¶ 22-24.

[51] *Kaplan Reply Affidavit,* ¶ 25.

necessary terminal equipment hardware. Combined, the product can be rolled out cheaper and faster, by avoiding the duplicative launch expenditures/evaluation processes, and gaining economies of scale in production and/or in procurement.

49. By facilitating the development and introduction of new services and packages of services, the merger of SBC and Ameritech will benefit consumers. The merged company will be able to develop and introduce these new services and packages of services at lower cost and more rapidly than SBC and Ameritech could achieve without the merger. Consumers will benefit directly from these new service offerings.

50. Research and development has the characteristic of a public good, which means that, as a matter of economic theory, the results of an R&D program can be applied to almost any scale of operations without diluting its value.[52] Thus, R&D performed by SBC can be used to benefit the operations of the merged company, as can R&D performed by Ameritech. Redundant R&D expenditures can be avoided and the remaining R&D delivers more "bang for the buck" because it benefits the total operations of the merged company. Similarly, the merger reduces the cost of research and development per unit of output that benefits from R&D and correspondingly increases the incentive to engage in R&D by permitting expenditures to be amortized over a larger customer base. All consumers will benefit directly, through better quality service, and indirectly, through positive spillovers into other sectors.[53]

51. The merger will accelerate the introduction of new products and services to consumers by exploiting complementary research and testing activities and by allowing the merged firm to

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[52] Robert G. Harris, "R&D Expenditures by the Bell Operating Companies: A Comparative Assessment," *Regulatory Responses to Continuously Changing Industry Structures*, Michigan State University, East Lansing: MSU Public Utilities Papers (1991), p. 249.

[53] Robert G. Harris, "R&D Expenditures by the Bell Operating Companies: A Comparative Assessment," *Regulatory Responses to Continuously Changing Industry Structures*, Michigan State University, East Lansing: MSU Public Utilities Papers (1991), p. 246.

spread the risks and costs of R&D and product introduction over a larger customer base. In addition to the cost savings from the combination of R&D, there are synergies to be obtained by having experienced and talented researchers exchanging new ideas and approaches to technological problems. The combination of research talent allows the organization to tap the collective expertise and experience of the two companies, and thus encourages the development and adoption of new technologies. Furthermore, the larger market area enhances market experimentation and new service introduction by providing more numerous and more diverse test markets.

52. A clear demonstration of the way a larger user base can accelerate the deployment of new technologies comes from SBC's announcement of a three-way marketing pact with Dell and Excite.[54] Under this pact, Dell will build into its computers high-speed xDSL modems that can take advantage of new services being offered by SBC Communications, which would then directly connect customers to a built-in personalized Excite start page. Indeed, the acquisition of Pacific Bell by SBC greatly facilitated the ability of SBC to form this pact through Pacific Bell's advanced plans and experience with xDSL, resulting in a more efficient rollout of xDSL service.[55] With the SBC-Ameritech combination, we would expect an acceleration in service integration and product extension agreements, and consumers in Ameritech's territory could benefit from this improvement and standardization in connectivity.

53. As a result of these efficiencies (diffusion of learning through the organization and a large base to recover the return on R&D investment), it is likely that the combination will increase the combined company's economic return on R&D investment. This would eventually lead to more capital being allocated to this activity and therefore result in an increase in R&D expenditure.

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[54] "SBC Communications, Dell Announce Initiative to Develop and Deliver ADSL Services on Dell PCs for High-Speed Internet Access," *SBC Press Release*, September 23, 1998.

[55] *Kaplan Reply Affidavit,* ¶¶ 21-24.

54. Third, most of the benefits that will be derived from the merger in terms of product development would be very difficult to accomplish in the absence of a merger. Research joint ventures have not proven to be very stable in telecommunications. Even Bellcore, once owned jointly by the BOCs, has been spun off because of the difficulty of operating this research company as a joint venture. Merging companies fosters cooperation and reduces the transaction costs associated with sensitive research in ways that cannot be duplicated by other arrangements. Thus, the benefits of scale and scope in R&D and product development are not likely to accrue in the absence of the merger.

55. In summary, the incentives and financial capability for SBC to increase its R&D expenditures increases as a result of this merger.

C. Global Competition

56. AT&T claims that there will be no enhanced global competition because SBC and Ameritech are already two well-positioned competitors in Europe.[56]

57. First of all, these firms have a relatively small European presence. Ameritech has a stake in Belgium, Denmark, Norway and Hungary. SBC has interests in France, Switzerland, and the U.K. Second, SBC and Ameritech do not have a presence in much of the rest of the world. Opponents admit that there are at least twelve significant competitors in Europe. The instant merger would enable SBC to better compete in that market to the benefit of U.S. customers.

58. It is evident that, on the global stage, both economies of scale and scope are important, as well as being able to offer a product line that is deep (multiple services) as well as geographically broad (multiple markets). Simply put, larger volume on a given route dramatically lowers costs

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[56] *AT&T Petition,* p. 44.

by spreading the large fixed costs of trans-oceanic cables (which now come only in enormous capacities), as well as enabling negotiations of more advantageous settlement rates with foreign telcos. AT&T and BT recently formed a global partnership, amassing the huge resources of AT&T and BT and their already extensive global presence.[57] It is highly significant that even these very large global players find the need to join forces in order to succeed on a global scale. MCI WorldCom likewise has a large global network with 300 offices in 65 countries.[58] Sprint is in league with France Telecom and Deutsche Telekom in carrying out its global strategy.

59. Larger size and scope also offer a unique advantage in this era of telecom deregulation with its associated instability (relative to the old days of franchise monopolies). Earnings streams are no longer certain. There is no secure marketplace. The diversification among markets can enable global companies to balance risks, as well as shift resources from one country to the other in response to episodes of intense change – e.g. a regulatory shift or privatization opportunity.

60. Today, telecommunications analysts consider an international strategy necessary (although no guarantee) for the long-term viability of a mainstream telecommunications carrier. Companies bereft of an international strategy will likely be subsumed into larger groupings or evolve into niche players. In conclusion, the global telecommunications market is undergoing profound change and those attempting to compete in it are adjusting themselves accordingly. "We are increasingly a global economy and corporate customers and clients are becoming more global. They want one telephone company to handle all their needs worldwide," said Paul Deninger, chairman of Broadview, an investment bank focusing on computing, communications

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[57] "British Telecom, AT&T pact shatters old defenses," *The San Diego Union-Tribune*, August 2, 1998, p. I-1.

[58] "Global Operations Overview," *MCI WorldCom website*, at <<http://www.mciworldcom.com/>>, downloaded November 7, 1998.

and media.[59]

IV. The Merger Will Not Harm Competition

61. Opponents to the merger make various claims about ways in which the merger will harm competition, either through reduced competition for certain telecommunications services or through the possibility of more coordinated interaction due to fewer RBOCs.

A. The Merger does not Lead to Increased Cartel Possibilities

62. Sprint's witnesses argue that the merger increases the likelihood of coordination among RBOCs by reducing the number of members necessary to form and enforce a cartel.[60]

63. There are two overarching points that should be made when considering this argument. First, ILECs operate in distinct geographic regions with no overlaps, and thus do not compete. There consequently would be no anticompetitive reason for the firms to coordinate. Since these firms do not compete, no anticompetitive harm could result from any coordination. Second, even if there were some attempt to coordinate in some anticompetitive way, there is sufficient competition from other sources to defeat the consequences of such an attempt.

64. The allegation that the merger would increase the possibility of cartel-like action is flatly inconsistent with developments in the marketplace. SBC and Ameritech are increasingly facing competition from CLECs, cable operators, IXCs, and others. Given the number of divergent interests of these competitors, it is simply inconceivable that they could be included in any cartel that would restrict competition.

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[59] "Telecom giants rush for global alliances," *London Sunday Times, Industry Watch,* August 6, 1998.

[60] *Farrell and Mitchell Declaration,* pp. 44-47.

65. Moreover, this allegation is contrary to the very purpose of this merger, which is the implementation of the National-Local strategy. That strategy will place SBC-Ameritech in competition with other major ILECs across the country, further negating any incentive to engage in cartel-like behavior. The recent announcements of Bell Atlantic and GTE to compete vigorously in some cities in SBC's and Ameritech's service territories further refutes these arguments.

66. For the same reasons, there is no basis for concern that the merger will facilitate some sort of implicit agreement among the ILECs not to compete with each other. The goals of the merger and the impact of technology on the telecommunications industry in the market in which they are potential competitors directly refute this hypothesis. This merger is designed to help SBC-Ameritech pursue a strategy of aggressively entering the local territories of other RBOCs. In fact, SBC plans to enter into 30 out-of-region markets, most within a year and a half after the merger is consummated.[61] Moreover, there are enough other firms in the industry, including ILECs and CLECs, with divergent interests that no such agreement could be sustained.

67. Another reason for skepticism regarding this allegation is the nature of technology in the telecommunications industry. The dynamic nature of technology in telecommunications means that the gains to such a strategy are severely limited. Even if the ILECs could agree on a scheme to avoid directly competing against one another, technology has made it possible for many firms to compete with ILECs in-region. Entry has occurred by IXCs , cable providers and other CLECs through a host of technologies including wireless local loops. The rapidly changing nature of technology means that ILECs stand little chance of keeping competitors out of their in-region markets, eliminating any incentive to engage in mutual forbearance.

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[61] *Kahan Reply Affidavit,* ¶ 22.

B. The Merger does not Discourage Smaller Entrants

68. Several opponents argue that the merger and the accompanying National-Local strategy will result in increased barriers to entry for small entrants.[62] Once again, this theory is not consistent with the facts from past mergers. The results are just the opposite. Contrary to the claims of opponents to the SBC-Pacific Bell merger, it is evident that entry has not been deterred by the merger but has burgeoned. As shown in Figures 1 and 2 below, the number of approved collocation applications in Pacific Bell regions has more than doubled in the few months since the merger compared to the nearly four years prior to the merger. In addition to the data shown in these figures, as of November 12, 1998 Pacific Bell has provisioned over 658 physical collocation cages in 196 wire centers and hundreds more are under construction.[63] Pacific Bell also has built and plans to build additional hundreds of cages for which there has not yet been a collocation application. These data make it crystal clear that the merger has had no deleterious effect on competition. The competitive concerns of opponents to the merger were shown to be nothing more than pure assertions and simply did not come to pass.

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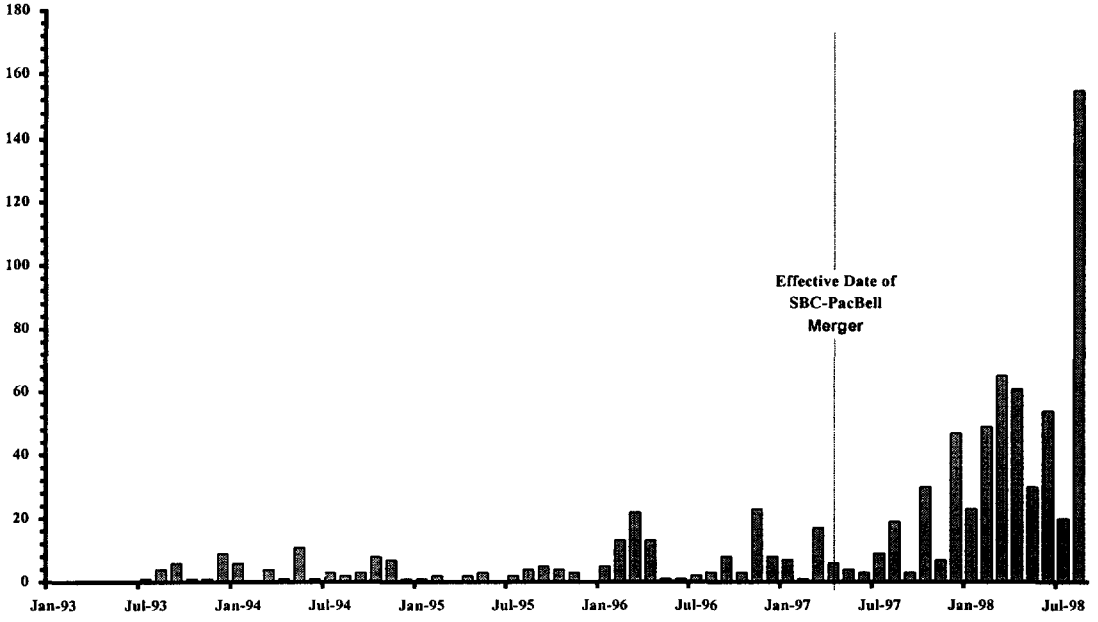
[62] *AT&T Petition,* p. 2; *Comments of the Telecommunications Resellers Association,* Before the FCC, CC Docket No. 98-141, October 15, 1998, p. 13; *Comments of the Consumers Federation of America and Consumers Union,* Before the FCC, CC Docket No. 98-141, October 15, 1998, p. 8; *Comments of the Missouri Public Service Commission,* Before the FCC, CC Docket No. 98-141, October 15, 1998, p. 1; and *Baseman and Kelley Declaration,* p. 38.

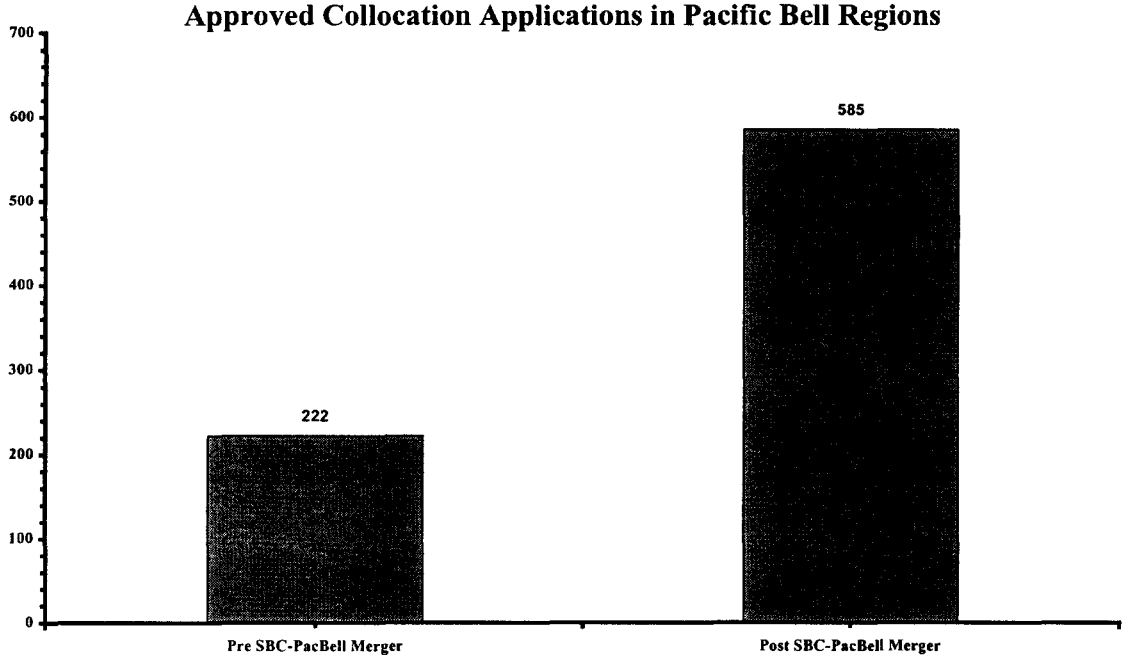
[63] *Pacific Bell internal data.*

Figure 1
Approved Collocation Applications in Pacific Bell Regions



Source: Pacific Bell internal data as of August 1998

Figure 2
Approved Collocation Applications in Pacific Bell Regions



Source: Pacific Bell internal data as of August 1998

69. A number of competitors have introduced switched local services in a variety of cities in California since the SBC-Pacific Bell merger took place.

- **Teligent,** a firm providing high bandwidth wireless local loops, recently launched services in San Francisco, Oakland and San Jose, in addition to its ten previously launched markets, offering integrated separate service for local, long distance and internet needs of small and medium sized business.[64]
- **Allegiance Telecom**, which received competitive local exchange service authority in April of

[64] Teligent currently operates in New York, Los Angeles, Chicago, Houston, Dallas-Fort Worth, San Antonio, Austin, Washington DC, Denver, Tempa, San Francisco, Oakland, and San Jose. Teligent plans to launch full commercial service in 15 markets in 1998 and at least 20 more next year. See: "Teligent Launches Revolutionary Communications Service in Northern California" *Teligent Press Release,* November 4, 1998; and "Not any company can have the communications power of a mega-sized company," *Teligent Company Website* at <<http://www.teligent.com/index.asp>>, downloaded November 6, 1998.

1998, initiated service in Los Angeles on October 5.[65]

- **Focal** began offering local service in San Francisco.[66]
- **GST** started offering local service in Los Angeles, San Francisco, Fresno, San Luis Obispo, and throughout the San Francisco East Bay/ Oakland market.[67]
- **ICG** began offering local service in San Jose.[68]
- **Level 3 Communications** acquired GeoNet Communications, a Northern California Internet Service Provider, to accelerate its plans to provide service in the Silicon Valley market.[69] Furthermore, Level 3 opened facilities in San Francisco, Los Angeles, San Diego, and Sunnyvale.[70] The company is currently using leased network capacity and intends to

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[65] "Allegiance Telecom Receives Competitive Local Exchange Service Authority in California," *Allegiance Press Release*, April 6, 1998. At <<http://www.allegiancetele.com/html/body_CLECca.htm>>, downloaded October 29, 1998. See also, "Allegiance Telecom Initiates Service in Los Angeles Metro Area; Primary Target of Sales force is Small and Medium-Sized Businesses," *Allegiance Press Release,* October 5, 1998. At <<http://www.allegiancetele.com/html/body_LAservice.htm>>, downloaded October 29, 1998.

[66] "Upstart Focal Communications Bucks the Telecom Trend in San Francisco," *Focal Press Release,* October 22, 1998. At <<http://www.focal.com/htm/press32.htm>>, downloaded October 28, 1998.

[67] "GST Telecommunications Reports All Fourteen Voice Switches Operational: Launches Local Phone Service in Los Angeles and Houston," *GST Press Release,* March 30, 1998. At <<http://www.gstcorp.com/press/gen89.htm>>. See also, "GST Telecommunications Launches Local Phone Service in San Francisco and Fresno," *GST Press Release,* March 26, 1998. At <<http://www.gstcorp.com/press/gen88.htm>>. Also, "GST Launches Local Telephone Service in San Luis Obispo," *GST Press Release,* January 20, 1998. At <<http://www.gstcorp.com/press/gen78.htm>>. Also, "GST Telecommunications Launches Local Phone Service in Two Markets: Northern California Network Operational," *GST Press Release,* December 9, 1997. At <<http://www.gstcorp.com/press/gen73.htm>>. All articles were downloaded on October 28, 1998.

[68] "ICG Communications Launches New San Jose Central Office and Switch Site: New Site Focus to Provide High-tech Area with ICG Telephony, Data Services," *ICG Press Release,* September 12, 1997. At <<http://www.icgcomm.com/news/releases/1997/09-12.htm>>, downloaded October 28, 1998.

[69] "Level 3 Communications/GeoNet Communications Acquisition Completed; Acquisition Accelerates Level 3 Business Plan," *Level 3 Press Release,* October 5, 1998. At <<http://www.l3.com/press_releases/05Oct98.htm>>, downloaded October 29, 1998.

[70] "Level 3 Communications Launches San Francisco Facility; Level 3 Expects to Have Operations in 12 –15 Cities by Year-End," *Level 3 Press Release,* October 26, 1998. At <<http://www.l3.com/press_releases/26Oct98_SF.htm>>, downloaded October 29, 1998. See also, "Level 3 Communications

seamlessly switch its customers to its own Internet Protocol (IP)-based network as it is completed.[71]

- **MGC** initiated local services in Covina, West Covina, Claremont, Upland, Chino, Pomona, Ontario, Whittier, La Habra, and Pico Rivera.[72]

- **NEXTLINK** rolled out services throughout Los Angeles County, Orange County and Silicon Valley, and has plans to expand into the San Francisco area.[73]

Launches Los Angeles Facility; Introduces First Step in Advanced Communications Services for Business Community; Los Angeles Kicks-Off Nationwide Rollout of Level 3 Offices," *Level 3 Press Release,* October 12, 1998. At <<http://www.l3.com/press_releases/09Oct98_LA.htm>>, downloaded October 29, 1998. See also, "Level 3 Communications Launches San Diego Facility; Introduces First Step in Advanced Communications Services for Business Community," *Level 3 Press Release,* October 12, 1998. At <<http://www.l3.com/press_releases/09Oct98_SD.htm>>, downloaded October 29, 1998. See also, "Level 3 Communications Launches Sunnyvale Facility; Introduces First Step in Advanced Communications Services for Business Community," *Level 3 Press Release,* October 12, 1998. At <<http://www.l3.com/press_releases/09Oct98_SV.htm>>, downloaded October 29, 1998.

[71] IP is a standard that describes how packets of data are transported across the Internet and recognized as an incoming message. "Communications Library," See MCI WorldCom website at <<http://www.mciworldcom.com>>, downloaded November 6, 1998. "Level 3 Communications Launches San Francisco Facility; Level 3 Expects to Have Operations in 12 –15 Cities by Year-End," *Level 3 Press Release,* October 26, 1998. At <<http://www. l3.com/press_releases/26Oct98_SF.htm>>, downloaded October 29, 1998. See also, "Level 3 Communications Launches Los Angeles Facility; Introduces First Step in Advanced Communications Services for Business Community; Los Angeles Kicks-Off Nationwide Rollout of Level 3 Offices," *Level 3 Press Release,* October 12, 1998. At <<http://www.l3.com/press_releases/09Oct98_LA.htm>>, downloaded October 29, 1998. See also, "Level 3 Communications Launches San Diego Facility; Introduces First Step in Advanced Communications Services for Business Community," *Level 3 Press Release,* October 12, 1998. At <<http://www.l3.com/press_releases/09Oct98_SD.htm>>, downloaded October 29, 1998. See also, "Level 3 Communications Launches Sunnyvale Facility; Introduces First Step in Advanced Communications Services for Business Community," *Level 3 Press Release,* October 12, 1998. At <<http://www.l3.com/press_releases/09Oct98_SV.htm>>, downloaded October 29, 1998.

[72] "New Phone Company Now Serving Whittier Area," *MGC Press Release,* June 30, 1998. At <<http://www.mgc.com/text/pressreleases/whittier.html>>, downloaded September 16, 1998. See also, "MGC Extends California Network," *clec.com,* June 30, 1998. At <<http://www.clec.com/latest/clecnews.cfm>>, downloaded October 28, 1998. See also, "MGC Offers Residential Phone Package for $15 Per Month: Includes Unlimited Local Calling, Custom Calling Features, Voice Mail, 10 Cents a Minute Long Distance, Plus Free Bonus Minutes," Press Release, March 12, 1998. At <<http://www.mgccom.com/text/pressreleases/CalPromo.html>>, downloaded September 16, 1998.

[73] "NEXTLINK Gears Up for Bay Area Launch," *clec.com,* May 20, 1998. At <<http://www.clec.com/latest/clecnews.cfm>>, downloaded October 28, 1998. See also, "NEXTLINK Nearly Ready for Bay Area Launch," April 14, 1998. At <<http://www.clec.com/latest/clecnews.cfm>>, downloaded October 28, 1998. See also, "NEXTLINK Communications Expands California Operations; Develops

- **WinStar Communications**, another wireless provider, launched competitive local service in Los Angeles and San Diego.[74] WinStar also obtained a license to provide service in Fresno and Bakersfield.[75]

- **TCG**, now part of AT&T, expanded its presence and service offerings in San Francisco and Sacramento by adding additional switches.[76]

70. Cable companies and providers of data services have also become more active competitors in California since the SBC-PacTel merger. Cox Communications has launched local service in parts of San Diego and Orange county.[77] Cox wired a 300-unit apartment complex in Orange County to deliver local, long-distance, data, and cable services.[78] Covad

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Telecommunications Network in San Francisco Bay Area," Press Release, January 14, 1998. At <<http://www.nextlink.net/xpage/xpr_corp011498b.htm>>, downloaded October 28, 1998. See also, "NEXTLINK California Telecommunications Company Brings State-of-the-Art, Fiber-Optic Communication Services to Southern California," Press Release, June 1, 1997. At <<http://www.nextlink.net/xpage/xpr_ca060197.htm>>, downloaded October 29, 1998.

[74] "WinStar – "The New Phone Company" – Launches Switch in San Diego; WinStar's National Expnansion Continues with Fourth Major Market in 90 Days; New Alternative to Pacific Bell is Dedicated to Customer Satisfaction," Press Release, June 25, 1997. At <<http://www.winstar.com/San_Diego_Release.htm>>, downloaded October 28, 1998. See also, "Winstar – "The New Phone Company" – Premieres in LA; WinStar's National Expansion Continues with Opening of Its Third Switch; Integrates Los Angeles by Crossing Pacific Bell and GTE Lines; WinStar Brings Fiber Quality to Capacity Starved California Customers," Press Release, April 17, 1997. At <<http://www.winstar.com/la_release.htm>>, downloaded October 28, 1998.

[75] "WinStar Lands Additional Licenses," *clec.com*, October 1, 1997. At <<http://www.clec.com/latest/clecnews.cfm>>, downloaded October 28, 1998.

[76] "TCG Announces Sacramento-area Expansion," *clec.com*, July 17, 1998. At <<http://www.clec.com/latest/clecnews.cfm>>, downloaded October 28, 1998. See also, "TCG Installs Second Switch in San Francisco," *clec.com,* January 27, 1998. At <<http://www.clec.com/latest/clecnews.cfm>>, downloaded October 28, 1998.

[77] "Cox Communications Rolls Out Telephony Services in San Diego County," *clec.com*, September 8, 1998. At <<http://www.clec.com/latest/clecnews.cfm>>, downloaded October 28, 1998. See also, "Cox Communications Launches Cox Digital Telephone," Press Release, September 10, 1997. At <<http://www.cox.com/press/press-133.htm>>, downloaded October 28, 1998.

[78] "Cox Introduces Full Telecommunications Services for Apartments," *Cox Press Release*, April 17, 1997. At <<http://www.cox.com/press/press-116.htm>>, downloaded October 28, 1998. See also, "Cox Launches Commercial C-LEC Service in Orange County," *clec.com,* September 10, 1997. At <<http://www.clec.com/latest/clecnews.cfm>>, downloaded October 30, 1998.

Communications began offering xDSL services in the Los Angeles area form Burbank to Orange County.[79] In June of 1998, Covad expanded its xDSL offerings in the San Francisco Bay Area and can now reach more than 1.1 million homes and businesses. ICG also has begun to offer xDSL services in California.[80]

71. The operators of long-haul fiber routes have also been active in California since the merger. GST activated service on its routes connecting Los Angeles and Phoenix and Los Angeles and San Francisco.[81] The company is planning on completing another route from San Francisco to Portland.[82] Electric Lightwave Inc. has plans to extend its Sacramento network into Roseville, California.[83] The company plans to complete a SONET network that includes a set of routes connecting Portland, Sacramento, San Francisco and Los Angeles and another set of routes connecting Portland, Salt Lake City, Boise, Las Vegas, and Los Angeles.[84] ELI recently

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[79] "Covad Communications Expands Availability of DSL-Based Data Communications Service into Southern California," *Covad Press Release,* August 10, 1998. At <<http://www.covad.com/about/press_release/press_081098.htm>>, downloaded October 28, 1998.

[80] "ICG Netcom Rolls Out DSL Service in California and Colorado; Company to Offer Competitively Priced, High-Speed Internet Access to Home Office and Business Customers Throughout its Regions," Press Release, October 22, 1998. At <<http://www.icgcomm.com/new/releases/1998/10-22.htm>>, downloaded October 28, 1998.

[81] "GST Turns Up First Customer on New Network Between Los Angeles and Phoenix. Operational Network Now Spans From San Francisco to Tucson," *GST Press Release,* October 15, 1998. At <<http://www.gstcorp.com/press/gen117.htm>>, downloaded October 28, 1998. See also, "GST Strengthens Presence in California's $11 Billion Communications Market. Completes Network Linking Communities from San Francisco to Los Angeles," Press Release, June 18, 1998. At <<http://www.gstcorp.com/press/gen104.htm>>, downloaded October 28, 1998.

[82] "GST Activates New Route," *clec.com,* October 15, 1998. At <<http://www.clec.com/latest/clecnews.cfm>>, downloaded October 28, 1998.

[83] "Electric Lightwave Receives Approval to Provide Competitive Telecommunications Service in Roseville; Expansion Creates Fiber Optic Network With More Than 200 Route Miles in the Sacramento Area," *ELI Press Release,* January 22, 1998. At <<http://www.eli.net/rosevil.htm>>, downloaded October 28, 1998.

[84] "Electric Lightwave Will Create Nation's Largest Western US SONET-Ring; Company Cites Immense Broadband Opportunity as Data Evolution Continues," *ELI Press Release,* August 25, 1998. At <<http://www.eli.net/w-sonet.htm>>, downloaded October 28, 1998.

entered a deal with Bay Area Rapid Transit to build fiber-optic links totaling 79 route miles along existing BART rights-of-way.[85] It is abundantly clear that the SBC-Pacific Bell merger has not had any negative effect on the development of local competition in California.

72. Several small companies, including Allegiance, MGC Communications, and Hyperion Telecommunications have had successful IPOs in recent months, indicating that capital markets believe that small players can be successful in this changing marketplace.[86] The market capitalization of these small telecommunications companies is substantial. Allegiance, MGC Communications and Hyperion today have a market capitalization of $507 million, $159 million and $492 million, respectively.[87]

C. The Merger will Bring Competition to Residential Markets

73. AT&T claims that the merger will only add competition to the already competitive large business market, not the residential or small business markets.[88]

74. This assertion is incorrect. The National-Local strategy envisions providing facilities-based services to residential customers, as well as large and medium-sized businesses. SBC has determined that the National-Local strategy, with its focus on large business anchor tenants "will justify the initial placement of personnel, switching capacity and the construction of fiber capabilities in those markets."[89] These facilities will be well placed to serve residential

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[85] "Electric Lightwave Signs Agreement with BART to Add Fiber Optic Capacity; Opens Offices in San Francisco and Los Angeles," *ELI Press Release,* March 18, 1998. At <<http://www.eli.net/bart.htm>>, downloaded October 28, 1998.

[86] "IPO Central," See <<http://www.ipocentral.com>>, downloaded October 29, 1998.

[87] "Company Snapshot," *CBS MarketWatch* at <<http://cbs.marketwatch.com>>, downloaded October 23, 1998.

[88] *AT&T Petition,* p. 36.

[89] *Kahan Affidavit,* 1998, ¶ 41.

customers as well, and SBC has plans to do so.[90] According to James Kahan, "SBC can efficiently and economically serve a large portion of the residential customers in these markets. Our strategy is to offer packages of local exchange, long distance and other features that are attractive to consumers who are high users of telecommunications services."[91]

75. To the extent that initial CLEC entry and the short-term justification for the National-Local strategy are predicated on the profitability of serving large business customers, this result only arises because of regulatory policy that maintains residential tariffs at or below the cost of serving these customers.

76. Today's regulated rates make the large business customer market highly profitable compared to the small business customer or residential markets.

> Because revenues are highly concentrated in network access, exchange services and interexchange services, these markets are easily segmentable and targetable. A rational competitor does not need to serve all geographic or customer segments to compete effectively in one or a few segments. Instead, the rational entrant will target its initial entry at the small share of the customers who account for a large share of revenues.[92]

Given the structure of local rates and its embedded cross-subsidies, entry appears to be profitable only in business or highly urbanized markets or only by very efficient and successful marketers of residential services. This is the product of regulation, not industry structure.

77. However, once the ILECs enter other geographic markets (as CLECs) to begin selling to the large business customers, it would be relatively easy and low risk for them to move into the

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[90] *Affidavit of Dennis W. Carlton,* Before the FCC, CC Docket No. 98-141, July 24, 1998, ¶ 9.

[91] *Kahan Reply Affidavit,* ¶ 29.

[92] *Affidavit of Robert G. Harris and Carl Shapiro,* In Support Of Pacific Telesis Group's Request for a Waiver to Permit It to Provide Interexchange Services to Customers in California, Civil Action 82-0192, Before United States District Court For The District Of Columbia, January 26, 1995, p. 21.

market for smaller customers (if prices begin to rise in those markets) by using assets that are already in place to serve large customers.[93]

D. Effects of the Merger on Internet Competition

78. MCI WorldCom has claimed that the merger between SBC and Ameritech will allow the combined company to exert market power over the Internet in the following three ways:[94]

1) Tying the use of SBC-Ameritech xDSL services to the use of SBC-Ameritech ISP services;

2) Applying access charges to transmission services purchased by ISPs, thereby price squeezing non-affiliated ISPs;

3) Consolidating the combined companies' Internet traffic in order to discriminate in peering and traffic exchange fees with smaller ISPs.

79. At the outset, it is nothing short of ridiculous to claim that this merger could adversely affect a market as wide open and competitive as Internet access. In fact, this merger will have pro-competitive effects in the Internet backbone business by establishing a new entrant which has a small existing base of ISP traffic to run over its planned IP backbone. Additionally, the combined company should be able to standardize and expedite the xDSL deployment process, providing high speed access availability at an earlier time than either company could have individually. We respond individually to each of MCI WorldCom's claims below.

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[93] See *Kahan Reply Affidavit,* ¶¶ 28-31, for a discussion of SBC's local entry strategy upon completion of the merger.

[94] *MCI WorldCom Comments,* pp. 37-48; and *Baseman and Kelley Declaration,* ¶¶ 97-102.

1. Tying ISP and xDSL Services

80. MCI WorldCom claims that "the current lack of local competition leaves Internet users with no choice but to use the ILEC's local network to reach the ISP of the user's choice,"[95] and that SBC- Ameritech will use anticompetitive conduct to force xDSL customers also to buy their ISP services from SBC-Ameritech. First, this purported issue has absolutely nothing to do with the merger. Any incentive or ability to engage in any such behavior is totally unaffected by the merger.

81. Second, there are an increasing number of competitive alternatives for accessing ISPs, apart from incumbent local exchange networks. Among the most important of these are:

- **Cable modems** use coaxial cable TV lines to send and receive data. Cable modem service providers such as @Home and Roadrunner typically deliver data transmission speeds in the range of 1.5 Mbps to 3 Mbps. Cable modems allow users to maintain an "always on" dedicated connection to the Internet at transmission speeds which exceed those provided by xDSL services over local phone networks. According to a Forward Concepts market study, "cable modems will win the lion's share of the North American residential broadband access market, and the installed base will reach over 7 million homes by 2002-more than four times the residential ADSL base."[96] Cable modem services are currently available in Alabama, Arizona, California, Connecticut, Florida, Georgia, Maryland, Illinois, Louisiana, Michigan, Nebraska, New Jersey, Oklahoma, Pennsylvania, Rhode Island, South Carolina, Tennessee, Texas, Virginia, and Washington. Indeed, at least 37 cable operators are now offering cable

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[95] *MCI WorldCom Comments*, p. 38.

[96] Will Straus, "Cable modems set to challenge ADSL," *CMPnet* at <<http://www.techweb.com/se/directlink.cgi?EET19971201S0122>>, downloaded November 9, 1998.

modem service in SBC's and Ameritech's regions.[97] This will be accelerated by AT&T's proposed purchase of TCI and through AT&T's joint efforts with TCI and Time Warner.[98]

- **Satellite** data services such as DirectPC achieve their high-speed network connection by by-passing the crowded landline computer networks that are frequently flooded or clogged. Users of satellite service request information from anywhere on the Internet over a regular telephone line. The requested information is then transmitted from the Internet to a satellite, from which it is beamed directly to the user's satellite dish at a speed of 400 Kbps. Satellite service is generally available to anyone with uninterrupted southern exposure.

- **Wireless** access channels such as digital cellular, PCS services, and MMDS services can be deployed very quickly and are much less expensive than traditional landline connections. Companies like Winstar, Teleport, and ART have been purchasing wireless licenses that they are now using to offer local connections to customers nationwide, at speeds up to 45 Mbps.[99]

- **CLECs** provide extensive Internet access by providing LAN connections to firms. This form of competition is a direct, high-speed substitute for LAN users. It provides Internet access at speeds in excess of those provided by xDSL. There are specific companies created just to serve these customers.

82. Third, any bundling of xDSL and ISP services by SBC-Ameritech into attractive

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[97] "Commercial cable modem launches in North America," *Cable Modem Info Center* at <http://www.cabledatacomnews.com/cmic7.htm>, downloaded October 20, 1998; "Cable connections: providers and pricing," *PC World* at <http://www.pcworld.com/hardware/networking/articles/feb98/1602p207g.html>>, downloaded October 20, 1998; and "Cable modem university: commercial deployment," *CATV* at <http://www.catv.org/modem/deploy/index.html>>, downloaded October 20, 1998.

[98] Leslie Cauley, "AT&T's chairman pressures cable firms on phone ventures," *The Wall Street Journal,* November 3, 1998.

[99] Paul Karzeniowski, "Trio gets mileage from wireless local access," *CMP Net* at <<http://www.techweb.cmp.com/cw/telepath/12tp3.htm>>, downloaded May 6, 1998.

packages would not be anticompetitive. All xDSL service providers have entered into partnerships with ISPs to offer high speed connections to the Internet. In fact, most leading xDSL providers such as Covad and Northpoint only provide xDSL connections through their ISP partners. Since the actual provider of xDSL service is transparent to the end users, MCI WorldCom's allegation that bundling xDSL and ISP services is anticompetitive is entirely baseless. If anything, SBC-Ameritech is simply reacting to the market's demand for packaged services.

83. Finally, SBC and Ameritech have very small shares of the ISP market despite the fact that they currently provide the underlying facilities most customers currently use to access ISPs. Even after the merger, SBC and Ameritech will still represent less than 2 percent of total Internet subscribers in the U.S.[100] It should be obvious that incumbent LECs have not used any market power in local service to affect competition in Internet access and there is no reason to believe they will be able to do so with xDSL.

2. Applying Access Charges to ISP Service to Price-Squeeze Non-Affiliated ISPs

84. MCI WorldCom also claims that "[b]y inflating the costs of competing ISPs, BOCs that provide Internet service along with local service would gain the same ability to impede Internet competition that BOCs have to impede competition in the long-distance market by unaffiliated long-distance carriers."[101]

85. Incumbent LECs can not apply access charges unilaterally to ISP calls. This is an issue

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[100] "U.S. Internet Household Forecast," *Emerging Technologies Research Group* at <<http://etrg.findsvp.com/timeline/forecast.html>>, downloaded November 10, 1998.

[101] *MCI WorldCom Comments,* p. 46.

which is currently being considered by the FCC and the courts. ISPs today do not pay access charges to the incumbents. In fact, the opposite is true in a number of cases. Incumbents each year pay disproportionate amounts of reciprocal compensation to CLECs under current interconnection arrangements. Because Internet calls have been considered local in some states,[102] local service providers of Internet callers have been required to pay the local service providers of the dialed ISPs reciprocal compensation on a per minute of use basis as set forth in their Interconnection Agreements. CLECs traditionally have aggressively marketed their services to ISPs because they recognize that the majority of the Internet users, or the calling parties, reside on the ILECs' networks. Since Internet traffic usually originates from the calling parties, CLECs stand to collect revenues both from the services rendered to the ISPs and from the disproportionate amounts of reciprocal compensation from the callers' service providers, the incumbent LECs. Moreover, the imbalance of traffic is further exacerbated by the longer duration of Internet calls. As result, CLECs have the ability to offer services to ISPs on far better terms and conditions than ILECs can.

86. Even if incumbents are free to apply access charges to ISP calls, a combined SBC-Ameritech does not have an economic incentive to price squeeze competing ISPs. If a vertically integrated LEC acquired an end-user ISP customer, the LEC would forego the access charges it would have received from the end-user's previous ISP, in exchange for the retail Internet service revenue from the end-user. If SBC-Ameritech engaged in a price squeeze by charging its retail end-user customer less than access charges plus the non-access network cost of the Internet service, it would forego the revenues (and profits) it had been receiving in the form of access charges. Such a strategy would only be profitable if SBC-Ameritech were able to force competing ISPs out of the market, allowing it to reap monopoly rates for Internet services at

[102] Numerous states have ruled in favor of competitive local exchange carriers that Internet traffic is local and therefore subject to reciprocal compensation.

some point in the future. Given the financial strength and market share of the top ISPs, this is extremely unlikely.

87. Once again we must point out that the combined SBC-Ameritech does not have any different incentives with regard to applying access charges to ISP calls than any RBOC does independently today, so this issue is irrelevant to the merger analysis.

3. Obtaining Market Power in the Internet Backbone Market

88. Finally, MCI WorldCom constructs the further hypothesis that, by price squeezing competing ISPs and tying its ISP service to its xDSL services and then routing the company's Internet traffic onto its not yet constructed IP backbone, SBC-Ameritech would "appropriate enough Internet traffic to give it power in the national market for Internet services."[103]

89. These claims are totally ungrounded and lack any merit. We explained earlier that Ameritech and SBC only have a very small share of total ISP subscribers both nationally and in-region. Furthermore, neither company currently operates an Internet backbone.[104] According to the *BoardWatch* Winter 1998 ISP Directory, there are 41 existing national backbone operators, of which only one is owned by an incumbent local exchange carrier, the GTE backbone.[105] The following table summarizes national backbones market shares according to *BoardWatch.*

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[103] *MCI WorldCom Comments,* p. 46.

[104] Internet backbones form the core of the Internet by aggregating traffic from ISPs, transporting and routing that traffic between entities (such as web site servers and user hosts) and providing ubiquitous connectivity between other backbones and ISPs.

[105] Note some of these backbones are commonly owned. See: "National Backbones," *Boardwatch* at <<http://boardwatch.Internet.com/isp/backbones.html>>, downloaded November 4, 1998.

National Backbone U.S. Market Shares[106]

Backbone	Market Share
MCI[107]	31.25%
Sprint	22.39%
UUNET/ANS/CIS	20.45%
AGIS	4.41%
GTE	4.11%
DIGEX	2.38%
CRL	1.96%
PSINet/iSTAR	1.76%
GoodNet	1.51%
DataXchange	1.00%
SAVVIS	0.95%
Verio	0.91%
Nap.Net	0.88%
CWIX	0.86%
GridNet	0.69%
AT&T	0.61%
IBM	0.59%
TCG CERFnet	0.47%
CAIS	0.46%
Other	2.35%
Total	**100.00%**

90. The idea that SBC-Ameritech – as a potential de novo entrant into the backbone market, lacking any existing market share, and having a trivial share of ISP subscribers – would be able to exert market power over any portion of the Internet is ridiculous. It is also highly ironic that MCI WorldCom is making these arguments, given that regulators required MCI to divest its

[106] "Backbone Market Share of 5,913 Backbone Connections from 4,470 Internet Service Providers," *Boardwatch* at <<http://boardwatch.Internet.com/isp/img/pg5b.jpg>>, downloaded November 4, 1998.

[107] MCI sold its Internet business to Cable & Wireless Co. to resolve antitrust officials' concerns surrounding its merger with WorldCom.

Internet assets before completing the merger with WorldCom. If MCI WorldCom had been permitted to retain its Internet assets post merger, it would have controlled over 50 percent of the backbone market in the United States, as shown in the above table.

4. The Merger is Likely to Lead to Benefits to Internet Consumers

91. Despite the large number of backbones operating currently, market share is highly concentrated with the top five providers controlling over 82 percent of the market. Any competitive inroads made by SBC- Ameritech in this market will be hard fought given current backbone providers' installed base of ISP and content customers and the bundled services (voice and data, wireline and wireless, local and interLATA) that will be available from backbone operators such as MCI WorldCom and Sprint. The entry of SBC-Ameritech into the Internet backbone market is likely to have a small but positive effect on competition in this market.

92. MCI WorldCom repeatedly bemoans the slow rollout of xDSL services nationwide. The combined SBC-Ameritech may be able to help develop industry-wide technical standards and procedures for deploying xDSL services which would help accelerate the delivery of the service across the country, providing substantial benefits to customers who will gain access to these services in a more timely and less expensive way than they otherwise would have.

V. Conclusion

93. This affidavit has addressed a number of the economic and public policy issues that were raised by opponents to the SBC-Ameritech merger. The merger, both in intent and in effect, is about creating a new national/ international competitor by integrating the management and operations of two non-competing firms.

94. The arguments and hypotheses voiced by opponents to the merger have been shown to be without any sound economic or public policy foundation. Many of them represent attempts by

competitors to prevent the formation of a more formidable competitor in a combined SBC-Ameritech. Not a shred of evidence has been presented by opponents that any of the list of concerns they present will indeed happen, nor did they happen in the SBC-PacTel merger where similar fears were also raised. Sound economic thinking and the evidence actually available leads to just the opposite conclusion. There have been previous telecommunications mergers and the effects have been positive. Efficiencies have been gained, saving the companies and society millions in resources. These efficiency gains are real and so are those that will come from this merger.

95. The public interest requires that firms like these be allowed to merge when abundant benefits to the firms and society will result and there are no demonstrated harmful effects. Opponents have attempted to fling every possible obstacle in the path of the merging firms and yet none of them has sufficient merit to begin to counterbalance the mergers' benefits.

96. As we stated in our initial affidavit, a host of consumer benefits will flow from the merger. Consumers should not be denied these benefits by hypothetical arguments or unsubstantiated claims. We strongly support the merger and urge the Commission to give it speedy approval.